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14 January 1983

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International Economic & Energy Weekly

25X1

Synopsis

Perspective—*The Nakasone Visit* 25X1

Prime Minister Nakasone's primary objective for his US visit will be to demonstrate to his constituency his ability to manage the bilateral US-Japan relationship. 25X1

Japan: Selecting an Economic Policy 25X1

Japanese Prime Minister Nakasone has decided to keep the mix of economic policies he inherited from his predecessor. We believe this program can, at best, achieve a small increase in growth and a minor decline in the fiscal deficit. 25X1

Japanese Robotics: Leading the World in Production and Applications 25X1

Japan has become the world's largest producer and consumer of industrial robots. While the United States is beginning to catch up, Japan will still maintain a substantial lead in the pace of robot application through the decade. 25X1

Japan's Growing Role in the World Machine Tool Industry 25X1

The Japanese are rapidly increasing their share of the world machine tool market and probably will maintain a dominant position for the foreseeable future. 25X1

Mexican Gas: No Financial Panacea 25X1

While many analysts point to Mexico's natural gas resources as a potentially major source of future foreign exchange earnings, we believe Mexico will be unable to boost such earnings over the next few years because of marketing and technical problems. 25X1

[redacted] 25X1

International Economic & Energy Weekly [redacted] 25X1

14 January 1983

Perspective

The Nakasone Visit [redacted] 25X1

On 17 January, less than two months after he was elected, Japanese Prime Minister Nakasone will visit Washington for talks with President Reagan. Nakasone was anxious to arrange this trip. Driving his sense of urgency has been:

- Unusually great tension in the relationship because of Japan's record bilateral trade surplus and US unemployment.
- Recent action by the US Congress on local content legislation and the approval of a nonbinding resolution calling on Japan to increase its defense effort.
- Major changes in the international arena, such as the new leadership in Moscow and some movement toward improvement in Sino-Soviet relations, which make early coordination of US and Japanese views important. [redacted]

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Nakasone's primary objective will be to demonstrate to his constituency his ability to manage the US-Japan relationship—a major requirement for a Japanese prime minister. He wants to project at home the image of a decisive leader who can move quickly to handle difficult situations. He hopes to ease bilateral tension in part by establishing a personal relationship with President Reagan and by going directly to the American people through news conferences and other media events. Nakasone apparently believes that his English language ability, his straightforward style, and his skill as an orator will serve him well. [redacted] 25X1

Nakasone will be able to point to some progress on bilateral issues. Late last year the Cabinet approved the FY 1983 budget, which includes an increase in defense spending of 6.5 percent over last year, rather than the 3.5 to 4 percent privately preferred by the Finance Ministry. Nakasone personally pushed through the larger increase and will characterize it as a significant achievement under Japan's current economic circumstances. Also, at the Prime Minister's direction, the Cabinet will probably approve a draft that meets US requests on transfer of defense technology. In addition, the Cabinet Council on Economics yesterday approved further moves on nontariff barriers and other trade issues before the visit. [redacted] 25X1

Nonetheless, Nakasone cannot appear to have been too accommodating to Washington. He is sensitive to any suggestion that he is following orders from the United States. He is particularly sensitive now because he has been criticized for showing too much haste in arranging the Washington trip. Nakasone will try to counter this by:

- Taking care of specific trade and defense problems ahead of time, so he will not look like he is caving in to US pressure.

- Presenting his own plan for the US-Japanese economic relationship. According to the press, Nakasone will propose "a World New Deal," which calls for the United States and Japan to work to solve world economic problems through cooperation on macroeconomic policy, trade, international finance, aid, and high technology. [redacted] 25X1

A successful visit is important to Nakasone. If bilateral tensions are lessened, he will be able to turn to pressing domestic problems, including a sluggish economy and a large fiscal deficit. Public US recognition of what Japan has done so far on trade and defense will help Nakasone demonstrate to his home audience that he has carried off the Washington visit well. He has, in fact, moved much more quickly than his predecessor—on the defense technology transfer issue, for example. [redacted] 25X1

While we believe Nakasone recognizes more needs to be done, he will be forced to turn his attention to domestic matters after the trip. Major local elections are scheduled for April, and national elections for the upper house—and perhaps for the lower house as well—will be held by the end of June. As to progress over the longer haul, Nakasone must be privately convinced that the pressure from Washington is still on. This will give him the ammunition he needs to push Japanese bureaucrats and politicians toward the more difficult concessions that lie ahead. [redacted] 25X1

[redacted] 25X1

Briefs

Energy

OPEC Crude Oil Production

Preliminary figures indicate annual average crude oil production for OPEC in 1982 was 18.8 million b/d, down 3.9 million b/d from 1981 and the lowest recorded yearly output for the organization since 1968. Saudi Arabia experienced the largest loss last year with production declining by 3.3 million b/d and its share of total OPEC output dropping 8 percentage points to 34 percent. Iran was the only large gainer; its output climbed almost 65 percent during the year to an average of 2.3 million b/d. Seven other producers and the Saudi-Kuwaiti Neutral Zone recorded declines ranging from 300,000 to 100,000 b/d, while only three members—Iraq, Ecuador, and Gabon—were able to hold their own. Libya, the only OPEC member other than Iran to record any gain in 1982, posted a modest 100,000 b/d increase. 25X1

OPEC: Crude Oil Production, 1982 *Million b/d*

	Quota	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Nov	Dec	Total
Total	**17.5**	**19.9**	**17.6**	**18.4**	**19.4**	**19.5**	**19.2**	**18.8**
Algeria	0.6	0.7	0.6	0.7	0.7	0.7	0.7	0.6
Ecuador	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Gabon	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Indonesia	1.3	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Iran	1.2	1.4	2.3	2.5	2.9	2.9	2.9	2.3
Iraq	1.2	1.5	0.8	0.8	0.8	0.8	0.8	1.0
Kuwait	0.6	0.7	0.6	0.7	0.7	0.7	0.6	0.7
Libya	0.8	0.8	0.8	1.4	1.7	1.7	1.7	1.2
Neutral Zone	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.3
Nigeria	1.3	1.4	1.3	1.2	1.4	1.4	1.2	1.3
Qatar	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Saudi Arabia	7.0	7.9	6.3	5.8	5.4	5.4	5.3	6.3
UAE	1.0	1.4	1.2	1.2	1.3	1.3	1.3	1.2
Venezuela	1.5	1.9	1.5	2.0	2.2	2.3	2.3	1.9

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OPEC crude oil production in December was an estimated 19.2 million b/d, down 300,000 b/d from the previous month. No country recorded production gains, while Nigerian output dropped 200,000 b/d to 1.2 million b/d, and Saudi Arabia and Kuwait both had slight declines. Seasonal demand pushed fourth-quarter OPEC production up to 19.4 million b/d, about 1 million b/d over third-quarter 1982. This still is almost 2 million b/d less than OPEC crude output in fourth-quarter 1981. OPEC is optimistic that first-quarter 1983 demand for its oil will hold at about 19.5 million b/d. Last year, however, production in the first period fell 6 percent from fourth-quarter 1981. [redacted] 25X1

Sweden Considering Purchases of Soviet Gas

The USSR reportedly is eager to export natural gas to Sweden by way of a proposed Nordic pipeline. Although Swedegas, a subsidiary of Sweden's state-owned oil company, Svenska Petroleum, and the Soviets have discussed prospects for such a gas import project on several occasions over a 10-year period, Moscow apparently has now suggested it may be willing to sell the gas at a price lower than that previously offered. Despite widespread doubts over the viability of the proposed project, which would extend the existing pipeline further into Finland and then into central Sweden, a decision on the project is not expected for some time. Beginning in 1985, Sweden will import small quantities of gas from Denmark, and Swedegas hopes that gas discovered in northern Norwegian waters will yield reserves sufficient to warrant construction of a pipeline through Sweden. [redacted] 25X1

Less Japanese Interest in Alaskan Oil

Prime Minister Nakasone is being advised not to emphasize the possibility of imports of Alaskan oil as a way to improve the trade balance with the United States. Japanese oil refiners and government energy experts are insisting that Alaskan crude is too poor in quality and too high in price. [redacted] 25X1

When crude oil was in short supply and prices rising, the Japanese believed importing Alaskan oil would be a good way to reduce dependence on the Middle East and at the same time correct the trade balance with the United States. The refiners, who have seen their profits reduced by the depreciation of the yen and by falling demand for energy, now are avoiding long-term commitments in favor of cheaper spot purchases. Faced with opposition from the industry and bureaucrats, Nakasone is unlikely to do more than keep the proposal alive for future consideration. [redacted] 25X1

International Trade, Technology, and Finance

Canadian Grain Sale to Poland

[redacted] Canadian Wheat Board will officially announce today the sale of 1 million tons of grain (worth US $150 million at current prices) to Poland. Deliveries are scheduled for April and May. In addition, rumors of a forthcoming sale to East Germany are surfacing. Canada probably will extend up to a US $200 million line of credit at around 10.5 percent (well above the Canadian Wheat Board's minimum rate) to finance the 25X1

sale. Although the Canadian Wheat Board can borrow at 0.25 percentage points below the Canadian prime—currently 9.74 percent—sales to Poland have ususally been 1.5 to 2 percentage points above LIBOR (9 percent in early January 1983). This will be Poland's first grain credit from the West since the imposition of martial law in December 1981. [redacted] 25X1

Discussions in the Canadian Government on extending credits for grain sales to Poland have been heated. The last long-term agreement expired at yearend 1982. Until now opponents of new credits, led by the Wheat Board, have prevailed. The decision to go ahead almost certainly was made at a high level. It is consistent with Prime Minister Trudeau's recent overtures to the USSR and hints more credits would be provided if martial law were eased. Moreover, western Canada's bumper crop has resulted in a 4-5-million-ton surplus available for export, and Ottawa is anxious for additional grain sales. [redacted] 25X1

Iranian-Nicaraguan Oil Deal

Iran reportedly has agreed to provide Nicaragua $25-30 million worth of crude oil this year on concessional terms. [redacted] 25X1 25X1

The oil, equivalent to about 20 percent of Nicaragua's crude imports last year, could go a long way toward easing the fuel shortage and may allow Managua to relax rationing. The Sandinista government imposed rationing in the middle of last year, when Venezuela suspended deliveries after Nicaragua failed to pay for previous shipments. Although Mexico—Managua's sole remaining supplier—increased shipments, technical problems in refining Mexican crude forced the Nicaraguans to cut consumption. Iran's action follows a request from Nicaragua last November—which Tehran refused because of its own financial problems—for a $30-50 million loan to help cover the growing foreign exchange shortage. [redacted] 25X1

National Developments

Developed Countries

EC Economic Growth Negative

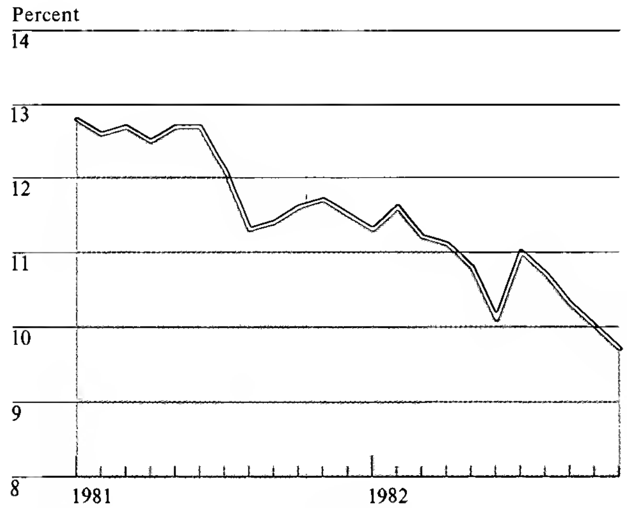
Largely as a result of lower exports, GDP in the European Community declined at an annual rate of 4.6 percent in third-quarter 1982—the sixth quarter of negative growth since the beginning of 1980. Among the Big Four—West Germany, France, the United Kingdom, and Italy—only the United Kingdom registered positive growth, 0.5 percent at an annual rate. Italy's GDP dropped at an 11.6-percent rate, while West Germany and France experienced negative rates of 5.0 percent and 3.2 percent, respectively. For the Ten, exports declined at an 8-percent annual rate in the third quarter, but were off a staggering 25-percent annual rate in Italy. Overall growth in investment and private consumption also was negative. For the year as a whole, the

European Commission estimates that GDP growth in the EC may have been only 0.3 percent, little better than last year's -0.6 percent. The Commission now estimates GDP this year will rise only 0.4 percent. This pessimistic outlook stems from expected slack LDC and East European import demand and slow economic recovery in the United States, as well as the dampening effect on world trade of mounting protectionism. [redacted] 25X1

EC Inflation Slows

Consumer prices in the European Community rose at a 9.7-percent rate for the 12 months ending in November, the slowest rate of inflation since July 1979. The halving of British and Irish inflation along with a 5-percentage-point drop in French price rises accounted for most of the improvement. While much improved from the November 1981 performance of 11.7 percent, EC inflation remains more than 4 percentage points above the US rate and almost 7 points above Japanese price rises. [redacted] 25X1

European Community: Consumer Prices[a]



EC	9.7
Belgium	8.9
Denmark	10.1
France	9.4
Greece	19.9
Ireland	12.3
Italy	16.5
Luxembourg	10.8
Netherlands	4.5
United Kingdom	6.2
West Germany	4.7

[a] Change from the same period of the preceding year.

[redacted] 25X1

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EC price increases should continue to slow in 1983. Most EC governments are keeping a tight rein on their budgets and money supply growth. Paris replaced the wage-price freeze that ended in November with another program designed

to be phased out gradually during 1983. The decline in raw material prices—including oil—as well as a continuing fall in the US dollar exchange rate should help keep West European import costs down. Although Rome and Athens intend to introduce new austerity measures, Italian and Greek inflation rates will remain well above 10 percent. [redacted] 25X1

Israeli Cost-of-Living Agreement

The government, Histadrut (the large labor federation), and the Manufacturers' Association have agreed on a new cost-of-living adjustment formula. The agreement, together with the recent public-sector wage agreement, represents a setback to Finance Minister Aridor's attempts to restrain real wage gains in order to control Israel's triple-digit inflation. Workers still will be able to bargain for additional wage gains at the industry and plant levels, thus making real wage increases probable. Labor has been able to realize real wage gains averaging 6.8 percent a year since 1975. Under the new formula, wages will be increased monthly by 80 percent of the rise in the consumer price index. Since wages currently are raised quarterly to compensate for 80 to 90 percent of inflation, labor gave up the potential for higher adjustments to ensure more frequent compensation. [redacted] 25X1

Greek Devaluation

In addition to last weekend's 15-percent devaluation of the drachma, Athens has indicated it will adopt other measures to encourage exports, restrict imports—particularly from its EC partners—and limit the inflationary impact of the devaluation, probably through tighter price controls. Greek exports plunged 17 percent in the first eight months of 1982, paralleling sharp declines in transfer receipts, private capital inflows, and earnings from shipping and tourism. Greek foreign exchange reserves fell dangerously low last summer, forcing Athens to increase the pace of its foreign borrowing. The devaluation should help restore Greece's slipping competitiveness; the move also indicates that Prime Minister Papandreou is moving toward more restrictive economic policies despite political pressures for less pragmatic action. [redacted] 25X1

Less Developed Countries

Brazilian Cash Position Under Increasing Strain

Despite strenuous efforts, Brazilian institutions have obtained few new short-term credit commitments from US regional banks. The financial bind has grown tighter as a result of requests for repayment of maturing short-term loans. Disbursement of the $1.5 billion bridge loan from the Bank for International Settlements should provide some relief. The Central Bank president has indicated that an additional $2 billion commercial bank loan will be required to prevent insolvency this month. If demands for repayment of short-term credits continue, the possibility of a sudden declaration of a payments moratorium will increase. [redacted] 25X1

Bolivian Debt Assistance

Argentina and Brazil—Bolivia's largest foreign government creditors—have taken steps to provide the Siles government some breathing room on its financial obligations. They recently agreed to reschedule over $570 million of Bolivian debt—$142 million by Brazil and $430 million by Argentina—converting delinquent obligations into longer term loans. Specific restructuring terms have not been determined, but bilateral negotiations with both countries are expected to be concluded early this year. In addition, La Paz has reached an agreement on $185 million owed by Argentina, with terms calling for immediate payment of $92.5 million for unpaid natural gas exports. [redacted] 25X1 25X1

Mobil Ends Libyan Operations

Mobil Oil Corporation recently announced its withdrawal from Libya and plans to pursue international arbitration of its claims against Tripoli. [redacted] 25X1 25X1 the unilateral manipulation of oil prices by the government destroyed the value of Mobil's concessions and caused a breech of existing agreements between the corporation and the regime. The Libyan National Oil Company has assumed responsibility for Mobil's operations, which account for 5 percent of Libya's oil production. Tripoli should have little difficulty maintaining oil production in these fields as required spare parts and technicians can be obtained through Western Europe and Canada. Last year, Libya settled a similar dispute with Exxon for $90 million a few months after Exxon's withdrawal. [redacted] 25X1

Exxon Divestment Talks With Pakistan Stalled

Exxon's negotiations with the Pakistani Government for the sale of its holdings in Pakistan have reached a stalemate because the government is reluctant to pay Exxon's asking price and wants the company to complete development of the country's Mari gasfield. Exxon wants $12.0 million for its existing investment in the field, but Pakistan has offerred only $4.5 million. Exxon wants to divest from Pakistan because returns on its various investments there are well below expectations. [redacted] 25X1

Talks also are clouded by the Ministry of Petroleum's objections to Exxon's attempts to sell its holdings to the Fauji Foundation. The Foundation is a military-owned organization for the investment of military pension funds and is now a major industrial conglomerate. Ministry officials fear that the Foundation would rival their control of the gas allocation process. Whatever the outcome of the negotiations, we believe that President Zia will try to maintain correct relations with oil companies—both foreign and domestic—in order to move foward with the country's energy development plan. [redacted] 25X1

Zambia Edges Toward IMF Agreement

The Zambian Government recently announced a series of measures to signal the IMF that Lusaka is serious about negotiating a $225 million, one-year standby loan. President Kaunda's call in late December for drastic government and private-sector spending cuts and the government's subsequent deregulation of prices on most goods clearly were designed to impress the Fund, according to the US Embassy in Lusaka. Last weekend, Lusaka devalued the kwacha, raised interest rates, and indicated that it will continue to pay the interest on its medium- and long-term debt but will suspend principal payments while it seeks a Paris Club rescheduling. IMF attitudes about the government's commitment to austerity will be heavily influenced by Zambia's 1983 budget—scheduled to be completed later this month. Even if the budget passes muster, the Fund probably will request further devaluation of the kwacha.

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Moroccan Financial Strains

Rabat's creditworthiness with the international banking community deteriorated again last year, and prospects for improvement remain limited in 1983. Banks in the United States, which hold approximately 10 percent of Morocco's $9.3 billion foreign debt, reportedly are reluctant to increase their exposure. With its debt service ratio already exceeding 40 percent and the likelihood that large current deficits will continue, Morocco is a strong candidate for some form of debt rescheduling this year. 25X1

Burmese Balance-of-Payments Problems

Burma is experiencing a foreign currency shortage for the first time in several years, according to the US Embassy. Export earnings from rice, metals, and timber have fallen because of low international commodity prices, and the Burmese have resumed oil imports because of problems with domestic production. As a result, resource-rich Burma, which grew at an average rate of 6 percent in recent years, faces a slowdown in economic growth in 1983. Current foreign exchange reserves are sufficient for only one and a half month's worth of imports, forcing Rangoon to cut capital imports and slow the implementation of development projects. In addition, we estimate that over a third of this year's foreign currency earnings will be needed to service Burma's $2 billion foreign debt. 25X1

Communist

China's 1983 Economic Plan

China's 1983 economic plan announced late last year calls for imports to increase by 25 percent—a major boost after two years of cutbacks. Imports would total $20 billion, surpassing the 1980 record of $19.3 billion. With foreign exchange reserves at record levels—$10 billion by yearend 1982—Beijing will be in a good position to import more goods needed to help expand heavy industry and agriculture. Japanese steel and machinery producers would be the main beneficiaries of such a move, while US firms would stand to gain

from increased sales of fertilizer, machinery, and technology. Beijing expects exports to increase by only 4.8 percent, resulting in a trade deficit of about $1.5 billion in 1983. In addition, China recently stated that it intends to seek foreign credits, especially long-term, low interest loans. [redacted] 25X1

China's anticipated surge in imports and apparent willingness to increase foreign borrowing presages a continued major role for Western equipment and technology in China's modernization program. Although the projected rise in imports will reduce China's trade surplus, the Chinese have traditionally understated their export growth, and a small trade surplus is likely this year. [redacted] 25X1

The plan for the domestic economy shows modest growth in 1983, indicating that the central authorities are still more concerned with improving efficiency than with short-term gains in output. Industrial production is projected to rise by 4 percent, the same as in 1982, and steel production will be cut to help reduce inventories. Grain and cotton output are both slated to rise by slightly over 2 percent. Slow growth in the energy sector—a 3-percent planned increase in coal output and no increase in oil production—may be a constraint on even the modest 1983 targets. [redacted] 25X1

Czechoslovak Interest in a Syndicated Loan

A Czechoslovak banker has confirmed to a US Embassy official that Prague is trying to raise $100-150 million through a syndicated Euromarket loan, its first since 1980. The timing and terms of the syndication are still uncertain, but we expect Prague to press for favorable terms—a five-year maturity and a spread of only 1 point over LIBOR. The banker also reported that Prague is considering releasing some previously withheld financial data to its creditors, a move that could improve chances for successful completion of the syndication. [redacted] 25X1

Prague's decision to seek new credits does not, however, signal an end to its conservative financial policies. The source reported that at the end of 1982 Czechoslovakia's net debt had fallen below $3 billion, the second lowest in Eastern Europe. Since 1979 Prague has been reducing its hard currency debt by running trade surpluses with the West at the expense of domestic growth. The Czechoslovak banker claimed Prague ran a hard currency trade surplus of $800-900 million last year following a surplus in 1981, which we believe totaled about $375 million. [redacted] 25X1

While the possible new loan is not essential to meeting Czechoslovakia's 1983 financing requirement, a successful syndication could help Prague obtain supplier credits at better terms and acquire more bank-to-bank loans. It would also imply that Western bankers are willing to differentiate among individual Communist Bloc countries to a greater degree than in the recent past. [redacted] 25X1

Japan: Selecting an Economic Policy

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Japanese Prime Minister Nakasone has decided to keep the mix of economic policies he inherited from his predecessor. With the yen appreciating, he will continue to ease monetary policy while holding a tight rein on government spending. We believe this program can, at best, achieve a small increase in growth. It will not reduce the trade surplus. While he will tinker with some policies, no options short of a radical shift away from his tight fiscal policy would add significantly to Japanese growth and reduce pressure on firms to export.

Sluggish Economy

The Japanese economy shows no sign of breaking out of its current slump:

- MITI projects a decline in industrial production in January after little or no growth in October-December.
- Other leading indicators remain weak.

Our analysis indicates that Japan will post only 2.3-percent GNP growth in FY 1982, which ends in March 1983.[1]

Almost all sectors of the economy remain weak. Machinery orders, particularly from overseas, fell sharply last quarter, as did output of consumer electronics. The consumer, despite gains in real wages, has not picked up the slack because the recession is trimming employment as well as hours worked. On the external side, export volume continues to slip and probably posted negative growth in 1982.

[1] Because of publication deadlines, all national income accounts in this paper are based on Japanese data prior to the official revisions announced in December. While the revisions of historical data will change our aggregate forecast, they should have no significant impact on the trends and policies identified in this paper.

Japanese economic policy has contributed to this weakness. Fiscal policy has been tight; Tokyo ordered cuts or low ceilings for most budget items in FY 1982 and FY 1983. Driving this policy has been Tokyo's concern over the sharp increase in the fiscal deficit in recent years. According to recent public statements, the Ministry of Finance fears that financing future deficits would be more difficult because many of the bonds floated in the late 1970s will be coming due shortly. Ministry of Finance (MOF) officials estimate revenue fell $11 billion short of Tokyo's goal in FY 1981—nearly 10 percent of all projected tax revenues—and could be $27 billion below target this fiscal year. 25X1

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To help cover this shortfall, Tokyo approved a supplemental budget in December. While it added $5.6 billion in expenditures, mainly for the reconstruction of regions damaged by natural disasters, and $2.4 billion in construction bonds for additional public works, it cut more than this from other programs, particularly from transfers to local governments. An investment tax credit to encourage capital spending also was dropped because of fears 25X1
it would add to the deficit. 25X1

Forecast for FY 1983

After approving the supplemental budget in late December, the Economic Planning Agency (EPA) released the officially approved outlook for FY 1983. Tokyo projects a 3.4-percent growth in GNP, slightly above the EPA's 3.1-percent forecast for this year. Domestic demand will account for 80 percent of the growth; the trade and current account surplus will edge up, according to Tokyo. 25X1

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Japan: Economic Indicators *Percent*

	1981	1982 [a]	1983 [a]
Real GNP growth [b]	2.9	2.3	3.4
Export volume growth [c]	11.6	−2.0	5.0
Import volume growth [c]	−3.5	1.0	7.0
Inflation [b]			
CPI	4.0	4.7	4.5
WPI	1.4	1.8	0

[a] Forecast.
[b] Fiscal year beginning on 1 April.
[c] Calendar year.

[redacted]

We agree with Tokyo's aggregate forecast. Roughly one-half the net income in growth should come from consumer spending, buoyed by a third year of low inflation, and private investment. Corporate spending should recover as industries rebuild inventories and export orders pick up somewhat. [redacted]

While fiscal policy will remain tight, the level of government spending should help economic growth in FY 1983. In FY 1982 it was a drag on the economy. Tokyo's official budget calls for a 1.4-percent increase in spending over the original FY 1982 budget. In reality, however, because of the cuts in programs made in December, the spending increase will be larger—probably closer to 6 percent. [redacted]

In 1983 export volume should register a 5-percent increase, if world trade recovers from its current slump. Import volume, on the other hand, could jump by almost 7 percent. Even so, the soft market for oil and raw materials should keep import prices down. Exports in dollar terms should be substantially larger than imports, yielding a $27 billion trade surplus and a $11-12 billion current account surplus. [redacted]

In our export forecast, we could be underestimating the aggressiveness of Japanese firms. The recent

Japan: Government Spending Growth *Percent*

FY1981	5.4
FY1982	−4.6
FY1983	5.8

[redacted] 25X1

yen appreciation has only eroded—not eliminated—Japan's strong price advantage. Most products are priced to sell at the 200 to 210 yen level and firms could cut prices to expand their market share. Without further appreciation, Japan's edge will improve; we expect Japanese inflation to be under US and European rates in 1983. Nakasone probably is aware of this. According to press reports, during his Washington visit, Nakasone will pledge to "maintain orderly exports." [redacted]

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Nakasone's Problem

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The new Prime Minister is not happy with Japan's lackluster economic outlook, but he is probably unsure about a solution. [redacted] 25X1
[redacted] Nakasone has stuck closely to his campaign pledge to control spending as a solution to the budget deficit. His principal economic advisers—EPA head Shiozaki, Finance Minister Takeshita, and former Finance Minister Watanabe—all support this position. The government rejected the powerful business lobby's effort to liberalize depreciation because of its impact on the deficit. [redacted] 25X1

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At a recent press conference, however, Nakasone hinted that some policy adjustments are possible. He refused to commit his administration to a firm date to balance the budget. [redacted] 25X1
[redacted] monetary policy probably will be relaxed further now that the yen has appreciated. Even if the Bank of Japan opts to cut interest 25X1

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rates, we believe such a move would spur little investment because rates are already relatively low. [redacted]

One possible adjustment that would have limited impact on the deficit would be to advance the schedule for government spending in FY 1983. Several previous Japanese prime ministers have front-loaded spending to provide some stimulus to the economy. Using our version of the EPA model of the Japanese economy, we estimate that spending about 65 percent of the estimated budget during the first half of the fiscal year would add a 0.3 percentage point to growth. In particular, private investment rebounded over 1 percentage point compared with our original forecast. Import volume increased slightly, reducing the current account surplus. [redacted]

Another Option

We also tested a less likely but more rewarding option—easing the reins on fiscal policy. If Tokyo increased FY 1983 government spending by an additional 1.5-percentage points, we estimate that GNP growth would approach 4 percent. The increase in outlays would add roughly $3 billion to Tokyo's fiscal deficit and bring government spending in real terms up to the FY 1981 level. Even without front loading the budget, the current account would be roughly $1 billion less than our forecasted $11-12 billion level. Combining higher spending with a front-loaded budget would have a greater impact on GNP and the current account. [redacted]

Inhibiting any move to an expansionist fiscal policy, however, is Tokyo's overriding concern for the fiscal deficit, now more than 6 percent of GNP. We believe Japanese anxiety is overstated. Because of its large savings rate—roughly 18 percent of GNP—Japan could finance a larger deficit in an attempt to spur growth and future tax revenues and reduce pressure to export:

- If Tokyo would edge up low interest rates, the banks would probably be willing to absorb more government debt.
- The Finance Ministry could expand its plans, already in the works, to place more government bonds in foreign markets. [redacted]

At this point, Nakasone appears strongly opposed to this approach. He rejected calls by opposition parties for a similar plan. Nonetheless, given his recent track record for taking bold action—for example, personally ordering an increase in defense spending and settling the long simmering aid dispute with Seoul—we cannot rule it out. He may take another look at his policy options as the mid-1983 national elections get closer. [redacted]

[redacted]

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Japan's Growing Role in the World Machine Tool Industry [1] [redacted] 25X1

Japanese manufacturers have taken a significant lead in the application of microelectronics to machine tools, a development that is producing a new generation of highly automated, general purpose machine tools. The Japanese are rapidly increasing their share of the world machine tool market and probably will maintain a dominant position for the foreseeable future. World leadership in development and commercial manufacture of these advanced machine tools confers substantial competitive advantage to other major industries as a result of the productivity gains generated by their use. [redacted]

Machine Tool Industry

The machine tool industry is a critical ingredient for any advanced economy. The technical nature of machine tool production combined with the wide range of product diversity has led to extensive specialization. As a result, most firms are small and typically manufacture only one or two types of machines. [redacted]

The industry's structure is in the process of change, however, as the new generation of high-technology equipment will lead to increasing concentration of market share in the hands of a relatively few large firms with the financial resources needed for new product development and the modernization of production techniques. For the most part, these changes are coming about because of a shift in machine tool demand toward numerically controlled (NC) and computer numerically controlled (CNC) machines. Now, an even newer generation of NC systems, known as direct numerical control (DNC), uses a computer to direct the simultaneous operation of a number of machine tools. [redacted]

[redacted]

Japanese Forge Ahead

Japanese firms are well positioned to take the lead in production and marketing of the new generation of highly automated, general purpose NC and CNC machine tools. Japan's advantage is derived in part from its strong domestic electronics industry and its achievements in computer and microelectronics technology. Moreover, the rapid growth of Japan's industry in recent years has helped its firms to achieve significant economies of scale and to rapidly upgrade their production processes to achieve high levels of efficiency. [redacted] 25X1 25X1

The Japanese industry makes extensive use of its own advanced machine tool designs. For example, the use of flexible, highly automated machine tool systems has enabled Japanese firms not only to upgrade productivity but to improve quality as well. Yamazaki Machinery Works, the second-largest producer of NC lathes in Japan, has recently opened a new plant to machine parts from castings for its machine tool products that requires only 12 workers rather than the roughly 200 needed in a traditional plant of similar capacity. Moreover, the parts spend an average of just three days in process instead of the three months required in conventional plants. [redacted] 25X1 25X1

The marketing strategies pursued by Japan's machine tool firms have helped the industry reach the high growth rates needed to achieve economies of scale and the rapid introduction of the latest production techniques. Output has been concentrated on NC machines, the fastest growing segment of the market. Moreover, Japanese producers have deliberately forsaken the market for large, high-powered and high precision NC and CNC machine

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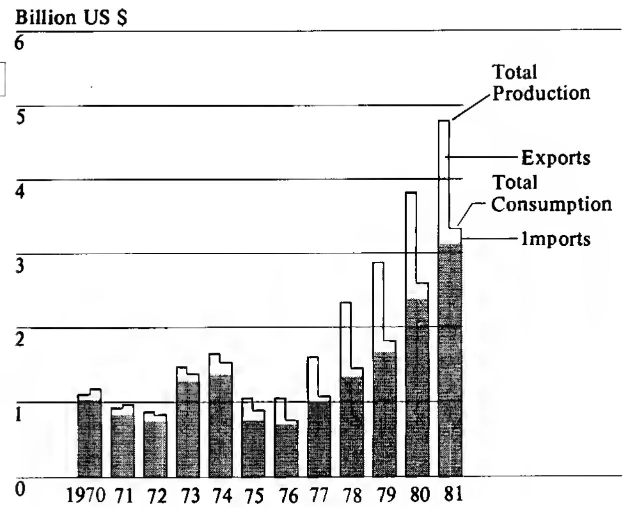
tools in order to reach high-volume production of less sophisticated equipment. Japanese firms focus on the mass production of medium-duty, low-power, general purpose machines that satisfy a wide range of applications. The Japanese equipment offered in this range of the market typically represents the best value and quality available. 25X1 25X1

Government Role

Tokyo's main role in support of the machine tool industry has been to create a business environment designed to encourage strong firms able to export. We believe this support has encouraged a more rapid growth of Japan's machine tool industry than would otherwise have been possible. Under the authority of a series of Extraordinary Measures Laws, Tokyo encouraged the formation of a machine tool cartel in 1956, which has concentrated production of each type of machine tool in the hands of the most efficient producers by ordaining that firms with a small market share discontinue production. We believe that Japanese firms are focusing on export markets as the principal area of company-to-company competition. 25X1

Japanese machine tool firms have benefited from a plethora of government programs directed both specifically at them and at industry in general. Programs supportive of industry as a whole have probably had their greatest impact on machine tool producers by making it easier for other firms to buy their products. The most important of these has been the use of accelerated depreciation to promote the purchase of NC machine tools. Programs to specifically support the machine tool industry have made funds available to Japanese machine tool firms on concessionary terms. The government has also funded research and development projects that benefit the Japanese machine tool industry. Direct grants have been made by various government entities, including the Research Development Corporation and the Agency for Industrial Science and Technology.

Japan's Machine Tool Industry



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Japanese Penetration of the World Market

Growth of Japan's machine tool industry accelerated rapidly after 1977, with exports accounting for much of the increase. The value of machine tool exports nearly tripled between 1977 and 1981. During this period, more than one-third of the growth in Japan's machine tool industry resulted from increased exports, primarily to the United States and Western Europe. The Japanese garnered the largest share of market growth in the United States during this period. Japan's emphasis on the production of advanced machine tools has made the developed countries the primary market for its exports. Japan's share of machine tools sales in the United States rose from 4 to 12 percent in these years. In 1980 Japan's three largest customers—the United States, West Germany, and the United Kingdom—accounted for 53 percent of Japanese machine tool exports compared with 32 percent just two years earlier. 25X1 25X1

Market Trends

The demand for machine tools is highly cyclical in the major industrial countries. The sharp growth in Japan's machine tool industry during the late 1970s partly reflected the high level of investment spending in the developed countries. Of particular importance was the investment activity of automakers in the United States, Japan, and West Germany. Between 1976 and 1980, US demand increased especially fast because of auto industry retooling. [redacted]

Beginning in 1981, however, recession and high interest rates precipitated a sharp fall in world demand for machine tools. In the United States, net new orders have fallen 75 percent since the first quarter of 1980. Orders in Western Europe also are down sharply. Primarily because of the contraction of its foreign markets, the Japan Machine Tool Builders Association forecasts a 7-percent decline in orders for 1982, the first downturn in seven years. [redacted]

The present cyclical downturn masks the strong underlying long-term demand for NC and CNC machine tools. This results from the fact that:

- Companies in high-wage countries can achieve very substantial reductions in production costs from the use of NC and CNC machine tools—particularly when they are paired with industrial robots.
- Over half the machine tools in use in the major industrial countries—and in the United States in particular—are 10 years of age or older, creating a major potential retooling demand.

In these circumstances, the industry expects a major rebound in demand for machine tools once economic recovery begins; NC and CNC equipment is expected to reap the lion's share of the growth. [redacted]

Outlook

The Japanese industry already has achieved much of the consolidation and modernization needed to fully exploit new machine tool technology. Government policy and the 1974-75 economic slump combined to force a major industry shakeout. Consequently, the Japanese industry is now dominated by relatively large, financially strong firms already well oriented toward the export market. [redacted] 25X1

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For these reasons, we expect Japanese firms to dominate world markets for advanced-technology machine tools. Japan's lead in modernizing production processes and the degree of industry concentration that it has reached will make it difficult for competitors to match Japanese prices and product quality. Moreover, the reputation for high-quality machine tools achieved by the Japanese in recent years will further guarantee their continuing success in the markets where they are already established. [redacted] 25X1

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[redacted] Japanese machine tool manufacturers appear determined to capture an overwhelming share of the market for advanced-technology machine tools. We expect the Japanese to branch out into more kinds of machine tools as the result of pressure to fully utilize their capacity. One US machine tool executive states that, at the current rate of capacity expansion, Japan will be able to supply 70 percent of Free World machine tool demand by 1985. [redacted] 25X1

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Implications for the United States

Although the United States has been a leader in developing new technology, US machine tool producers—according to many industry experts—are ill positioned to meet the Japanese challenge. Many US corporations have been slow to assess developments in Japan, and because of the recession they

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lack the financial means to react. Industry profitability—needed to finance R&D as well as new production equipment—is further constrained by the eroding US position in the world market; imports now account for 30 percent of the domestic market while exports have fallen to 10 percent of US production. [redacted] 25X1

The United States still retains an advantage in the most technologically intensive sectors, especially flexible manufacturing systems (FMSs), which integrate groups of machining centers through the use of computerized controls. The US industry has gained considerable experience with complex machining systems, and there are already several large users of FMSs in the United States. Competition in this field is sure to be intense, however. In addition to Japan, West European countries are devoting considerable R&D to the mastering of this technology and have initiated grant and loan programs to make it available to their manufacturing industries. [redacted] 25X1

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Mexican Gas: No Financial Panacea

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Many analysts point to Mexico's natural gas resources as a potentially major source of future foreign exchange earnings. Gas exports to the United States brought in about $500 million in 1982, and analysts point out that Mexico currently flares twice as much gas as it exports.

Despite this potential, we believe Mexico will be unable to substantially boost gas export earnings over the next few years. For one, Mexico would have to reduce prices to increase sales in the US market. Also, it will be some time before facilities are completed to reduce the amount of gas flared. Lastly, we believe production of nonassociated gas will decline through mid-decade.

Current Production and Exports

According to Pemex, Mexico's state oil company, Mexican natural gas production (including flared gas) averaged 4.2 billion cubic feet per day (cf/d) during January-September 1982, an increase of nearly 5 percent from year-earlier levels. These statistics, however, reflect a sharp slowdown in the rate of increase for Mexican gas production, which grew at an average annual rate of nearly 20 percent during 1978-81. In 1981 Pemex exported about 290 million cf/d of natural gas to the United States, earning about $530 million. In the first nine months of 1982, Pemex was able to deliver only about 260 million cf/d—almost 15 percent below the contracted volume of 300 million cf/d—because of rapid increases in domestic consumption and technical difficulties in gas processing and distribution. Although Pemex officials are confident that these problems will be overcome in 1983,

Exports Through Mid-decade

Mexican gas exports over the next few years will depend on production, transportation and processing capabilities, domestic consumption, and demand in the United States. 25X1 25X1

We believe nonassociated ***gas production,*** which currently accounts for nearly one-fourth of Mexico's gas output, probably will decline steadily at least through the mid-1980s. Mexico now produces about 1 billion cf/d of nonassociated gas, most of which does not require desulfurization. Production from Mexico's Reynosa fields along the Texas-Mexico border has declined in the past two years from about 400 million cf/d to 375 million cf/d. The nearby Sabinas Basin has been a major disappointment to Pemex; production there has declined abruptly from about 180 million cf/d in 1979 to about 75 million cf/d currently. Nonassociated gas production from the Ciudad Pemex fields in the south is currently about 550 million cf/d. 25X1

As to gas associated with oil production, output is expected to decline in the Reforma fields, which supply two-thirds of associated gas. According to both our own analysis and Pemex forecasts, gas production from these fields—currently about 2.2 billion cf/d—is unlikely to ever exceed 2.6 billion cf/d. Associated gas production from offshore fields in the Bay of Campeche is currently about 700 million cf/d and associated production from older onshore fields totals 350 million cf/d. Virtually all of Mexico's associated gas is sour,[1] requiring desulfurization before it can be utilized or transported over long distances. 25X1 25X1

[1] Gas containing significant amounts of hydrogen sulfide and/or carbon dioxide. 25X1

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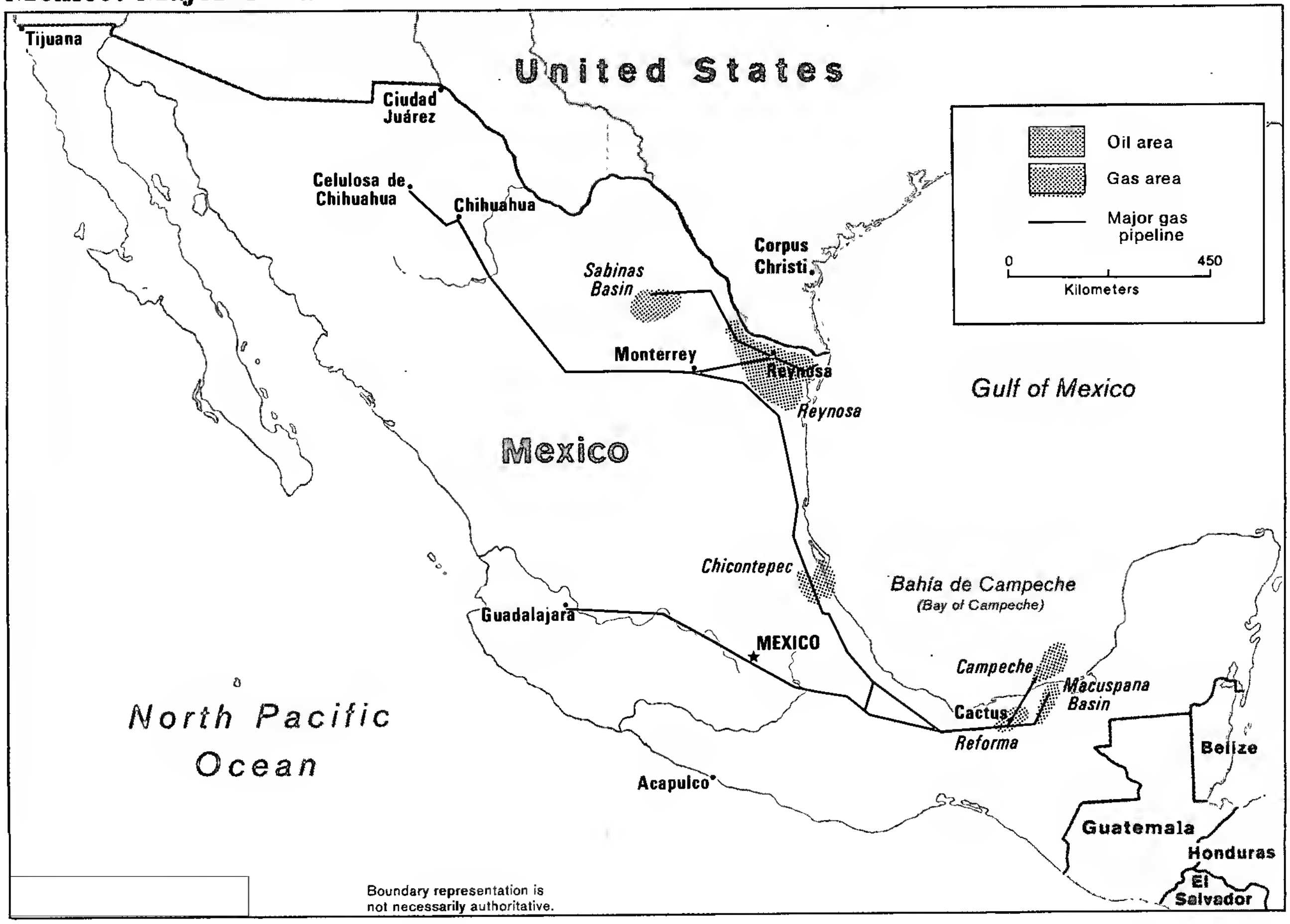
Mexico: Major Oil and Gas Areas



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If Mexican oil production remains near current levels over the next several years, gas production will probably remain at about the present level of 4.2 to 4.3 billion cf/d. Gas flaring, however, would be expected to decline from about 600 million cf/d presently to nearly zero by 1985, assuming gas collection and cleaning facilities are built.

Mexico faces a lengthy and expensive task in its efforts to eliminate flaring by upgrading its ***gas and processing capabilities.*** In 1981 Pemex completed a 915-millimeter pipeline to transport gas from

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Mexico: Natural Gas Production

Million cubic feet per day

	1977	1978	1979	1980	1981	1982 [a]
Production	**2,000**	**2,560**	**2,920**	**3,550**	**4,060**	**4,250**
Flared	600	710	360	440	665	600
Delivered to pipelines	1,400	1,850	2,560	3,110	3,395	3,650
Consumption	1,395	1,850	2,560	2,830	3,105	3,380
Exports	5	0	0	280	290	270

[a] Estimated.

[redacted] 25X1

Campeche to onshore treatment facilities at Ciudad Pemex and Cactus. By the mid-1980s this line was expected to transport one-third of Mexico's total gas production. Installation of compressors at seven platforms along the pipeline—each platform costing about $80 million—is far behind schedule. [redacted] sections of the underwater pipeline were improperly coated during construction and are now severely corroded and leaking gas. As a result, the flow of gas through the pipeline has been reduced until repairs can be completed. [redacted]

[redacted] the availability of treatment facilities for gas desulfurization and extraction of gas liquids is the chief constraint to utilization of new gas recovered from offshore fields. Although the capacity of these facilities is scheduled to be sharply increased over the next three years, projected capacity could still fall short of processing requirements. If Pemex were to boost oil production to levels projected in the Pemex study prepared for Mexico's new president, as much as 800 million cf/d of sour gas from Campeche and the other fields would have to be flared in 1983 because of a lack of desulfurization facilities. We believe accelerated construction of treatment facilities probably could solve the problem by late 1984 or early 1985 but would cost several hundred million dollars. Increased natural gas exports would also require expansion of pipeline facilities both in Mexico and the United States. [redacted]

Since rejecting plans to export 2 billion cf/d of gas to the United States in 1977, Mexico has made a concerted effort to increase ***domestic consumption,*** thereby freeing crude oil for export. Gas exports to the United States have been limited to 300 million cf/d, and a 12,000-kilometer national pipeline network has been constructed. Pemex data indicate 25X1 that Mexican consumption of natural gas has increased at an average annual rate of about 20 percent since 1977 approaching 3.4 billion cf/d in 1982. Nearly 90 percent of the gas used domestically is consumed by industry—for process heat 25X1 and electricity generation—or by Pemex as a refinery fuel. About 9 percent is used as petrochemical 25X1 feedstock. Residential and commercial use is growing rapidly, but still accounts for only 1 percent of total consumption. [redacted] 25X1

The growth of natural gas consumption will probably slow over the next two or three years as a result of the slowdown in Mexico's economic growth and recent government decisions to increase domestic gas prices—particularly a June 1982 increase that raised gas prices relative to those for fuel oil. Even though both fuels are still heavily subsidized, gas prices per million BTU are now nearly 70 percent higher than fuel oil prices. Although most Mexican industrial facilities are capable of burning gas or

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fuel oil, we judge that Mexico does not have the ready capability to replace large quantities of natural gas in the near term because of limited domestic production of residual fuel oil. Moreover, Pemex—which could potentially make a large contribution to reducing domestic gas usage—is resisting fuel switching because of increased maintenance problems associated with burning high-sulfur fuel oil. [redacted]

Given the ***weak US market,*** which analysts believe will continue over the next few years, Mexico probably cannot substantially increase gas exports without a major cut in prices. Significant quantities of US natural gas are shut-in due to reductions in demand caused by conservation and the recession. Most of this gas would be available at prices below the current border price for Mexican gas of $4.94 per million BTU. Furthermore, government regulations would allow US producers and consumers to contest increased imports of Mexican gas when cheaper supplies are available. Such proceedings could take one to two years. [redacted] Mexico may be forced to lower prices just to maintain exports at current levels. Take-or-pay provisions in the US-Mexican contract require that US companies take at least 180 million cf/d. [redacted]

A recent industry study indicates that the surplus of gas in the United States could persist into the late 1980s. According to the study, oil prices will decline through the mid-1980s, and residual fuel oil will be a major competitor to natural gas in the industrial sector. As a result, gas demand is seen as remaining flat, and gas shut-in problems are expected to persist into the mid-1980s. Even with a moderate economic recovery, several other industry forecasts show a decline in gas demand through 1985 and only a slight increase by 1990. [redacted]

Beyond 1985

Even beyond mid-decade, we are not sanguine about Mexico's prospects to increase gas exports. According to Pemex, Mexico's proved gas reserves now stand at 75.4 trillion cubic feet (tcf). Based on our analysis of production data, drilling results, and other geological information, we believe Mexico's official reserve estimate substantially overstates the size of proved recoverable reserves. Altogether, we believe proved reserves total no more than 35 tcf. [redacted] 25X1

[redacted] 25X1

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In our judgment, substantial additional exploration and development drilling will be needed to better estimate Mexico's recoverable reserves of natural gas. Drilling to date suggests that the greatest potential for new gas will be from medium-gravity crude fields in the offshore Campeche area. Good prospects may exist in the offshore portion of the gas-producing Macuspana Basin south of Campeche, but it will probably be several years before Pemex begins drilling for gas in the area. [redacted]

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Even if more gas is available, Mexico will have to overcome competition from Canada for increased sales to the US market. Canada now faces a sizable gas surplus of its own and the government has taken preliminary steps to pave the way for a substantial increase in gas exports over the decade. Canada's National Energy Board (NEB) has already authorized exports of up to 4.4 billion cf/d of gas to the United States—almost double current exports—and a number of companies are still seeking export permits. According to Canada's Energy Minister, the NEB is likely to conclude that Canada has an exportable gas surplus of 10 to 15 tcf, enough to allow export of an additional 2 to 3 billion cf/d over the next 10 to 15 years. [redacted]

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